Nationalisation and Restructuring
Royal Bank of Scotland (2008)

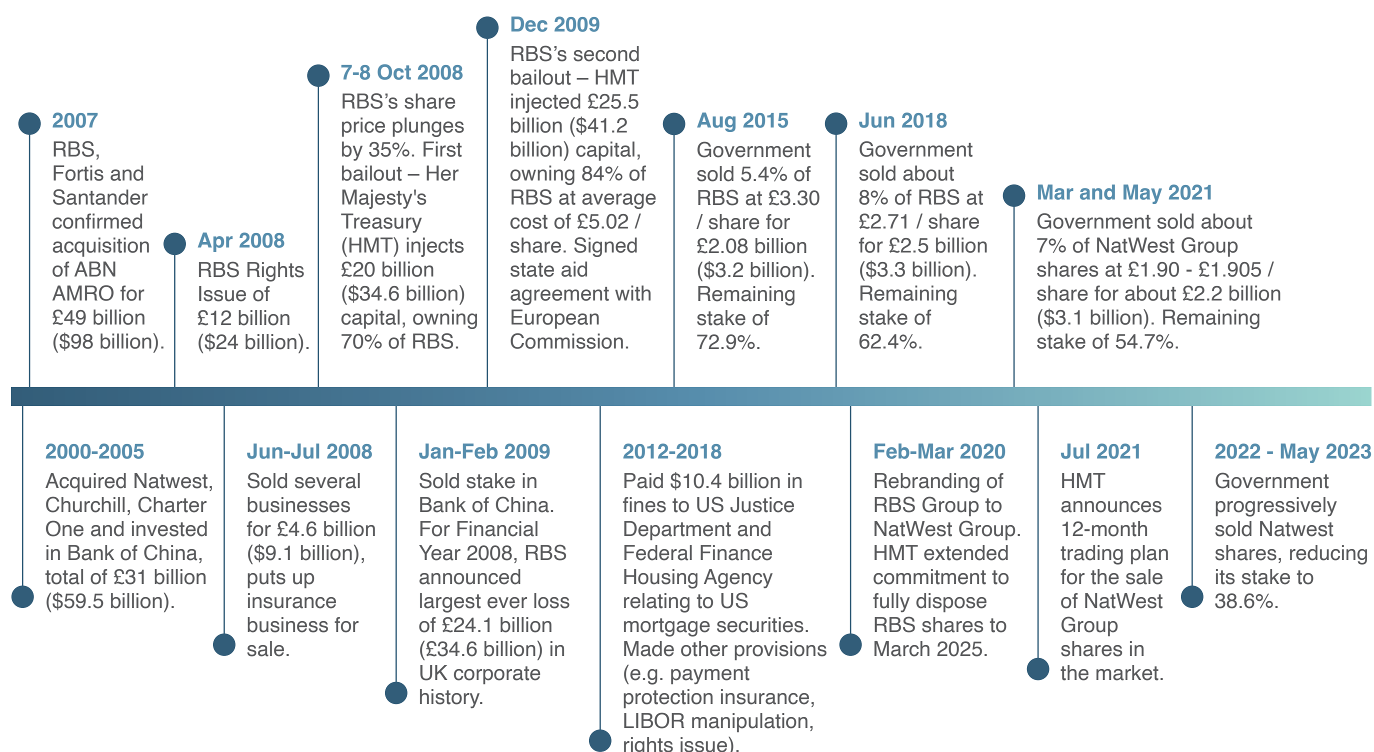
Background and context

The founding of the Royal Bank of Scotland (RBS) dates back to 1727. RBS's business portfolio included investment, corporate and retail banking in the UK and across the world. From 2000 to around 2007, it had embarked on a series of acquisitions, including NatWest, Churchill, Charter One, and ABN AMRO. In particular, the ABN AMRO acquisition was then the biggest deal in financial services history. At its peak, RBS was the largest bank in the world, as measured by assets of £1.9 trillion ($3.8 trillion) which was more than the then UK GDP. RBS was named Global Bank of the Year in 2007. It employed 226,400 staff, and had the widest network of 2,278 branches across the UK. It also owned Citizens Financial Group in the US and prior to the GFC, was the second largest shareholder in the Bank of China.

There were seven inter-related factors that contributed to the collapse of RBS, namely, weaknesses in its capital position, over-reliance on risky short-term wholesale funding, uncertainties about its underlying asset quality and lack of scrutiny by the UK Financial Services Authority (UK FSA), losses in credit trading activities (under-estimated by RBS and UK FSA), the poor due diligence in the acquisition of ABN AMRO, the overall systemic crisis that exacerbated RBS's vulnerability to failure, and lastly, deficiencies in the management, governance and culture of RBS.

Relative to peers, RBS had chosen to be lightly capitalised (using lower quality forms of capital), and had been more reliant on wholesale and overnight funding. According to the UK FSA's estimates, under Basel III, RBS's common equity Tier 1 ratio was only 2.5% as at end-2007, and the LCR stood at only 18% to 32% as at end-August 2008.

The acquisition of ABN AMRO in 2007 proved a step too far. This eroded RBS's capital adequacy, increased its reliance on short-term wholesale funding (the acquisition was funded primarily via short term debt) and resulted in significantly higher exposures to structured credit and other asset classes, which was to lead to large losses. Additionally, the due diligence was visibly inadequate relative to the risks being assumed – RBS was reported to have received only "two lever arch folders and a CD's" worth of information from ABN AMRO for an acquisition to the tune of £49 billion ($98 billion).



Resolution actions

In the first three quarters of 2008, RBS took recovery actions such as recapitalisation via a rights issue of £12 billion ($24 billion). It also carried out the sale of businesses, including Angel Trains and Tesco Personal Finance, for a total of £4.6 billion ($9.1 billion). However, in August 2008, RBS reported its first loss in 40 years. Subsequently, on 7 October 2008, RBS's share price plunged 35% and it fell in critical danger of running out of money. On the same day, the Bank of England (BoE) provided ELA to RBS in US dollars, and subsequently in sterling. Use of the BoE's dollar facility peaked at $25 billion on 10 October 2008, and the sterling facility at £29.4 billion ($47.9 billion) on 27 October 2008. RBS made final repayment of the ELA on 16 December 2008.

On 8 October 2008, the UK government announced a package of support measures for the financial system, comprising provision of capital to banks and a credit guarantee scheme (CGS) (government guarantees for new short and medium-term unsecured debt issuances). RBS received 80% or £20 billion ($34.6 billion) out of the £25 billion ($43.2 billion) of the capital made available to banks. It also proceeded to issue debt under the CGS. Besides RBS, the UK financial system was also reeling from capital injections required to save HBOS and for Northern Rock's nationalisation in early 2008.

In October 2008 and January 2009, the CEO and Chairman of RBS were replaced. This was followed by significant changes to the board. In June 2009, the former CEO, Sir Fred Goodwin, agreed to give up £200,000 a year of his pension of £703,000, in order appease public anger. He was later stripped of his knighthood.

> ***The internal bad bank by RBS will quickly and efficiently dispose of risky legacy assets that remain on its balance sheet, without the use of fresh taxpayer funds***
>
> Her Majesty's Treasury

In 2009, a key component in restructuring RBS was the establishment of an internal non-core division to take on bad assets worth £258 billion ($426 billion) or £171 billion ($282 billion) of risk-weighted assets. By 2013, the non-core division had reduced unwanted assets by 89% to £29 billion ($48 billion), representing about 4% of RBS's funded balance sheet (2009: 21%). In 2014, RBS stepped up its programme to deal with troubled assets by setting up an internal bad bank – RBS Capital Resolution (RCR) – with a renewed focus on eliminating RBS's highest-risk assets, stronger oversight (from non-executive directors) and improved disclosures. In November 2013, Her Majesty's Treasury (HMT) published a detailed review supporting RBS's approach for an internal bad bank. The review concluded, among others, that an external bad bank (requiring 12-18 months to establish) would not facilitate a faster return to the private sector than an internal one. It took RBS close to nine years to deal with bad assets from 2009 until closure of the RCR division in November 2017.

The long, winding and costly path of RBS's protracted return to the private sector

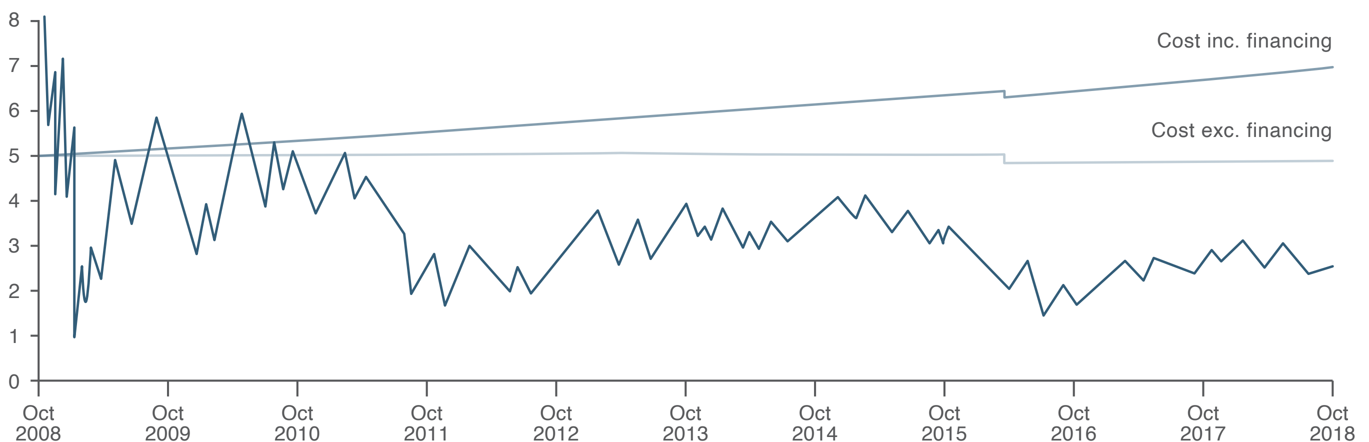
Post-nationalisation, RBS underwent several strategic transformations under three different CEOs – Stephen Hester (October 2008 to 2013), Ross McEwan (October 2013 to 2019) and Alison Rose (November 2019 to current) – and only paid out its first dividend to ordinary shareholders in 2018. For almost a decade, it had been confronted with the multiple challenges of internal restructuring, a difficult operating environment and recurring legacy issues of misconduct. The latter saw RBS pay out total settlements of about £20 billion ($27 billion) from 2012 to 2018, including those related to US mortgage-backed securities, LIBOR manipulation, the 2008 rights issue, payment protection insurance, and with the EU for RBS' state aid.

As part of the government bailout in 2009, RBS had agreed with the EU to divest 316 branches of its operations (under Williams & Glyn) to resolve competition concerns in the concentrated UK SME banking sector. In place of that commitment, in 2018, RBS agreed to set up a fund of about £835 million ($1.1 billion) to help UK's 'challenger banks'[68] compete with and obtain a 3% market share from RBS in the area of business banking.

The strategic objective of the HMT was to return RBS to the hands of the private sector, while realising the best possible value for its stake, so that funds could be released to reduce national debt and provide more resources to support economic recovery. This precarious trade-off saw the UK government taking a phased approach to twice reduce its equity stake in 2015 and 2018, booking total losses of £3.2 billion ($4.5 billion). Imputing the cost of financing, as estimated by the UK National Audit Office (NAO) in 2015, this cost has risen to £5.2 billion ($7.3 billion). As at March 2020, the UK Office for Budget Responsibility (OBR) estimates that saving RBS cost the public a sum of £32.1 billion ($39.8 billion). Despite its efforts, the UK government still holds 62.4% in RBS. In March 2020, owing to market conditions, HMT extended its timeframe to fully dispose of the RBS shares to March 2025.

Following share sales in 2021 to May 2023, the UK government held a remaining stake of 38.6% in RBS (rebranded as NatWest Group). In 2021, HMT announced a 12-month trading plan - beginning in August 2021 - for further share sales in the market. In June 2022, the plan was extended by another 12 months to August 2023.

Figure 3: RBS share price vs cost to public purse
£ per share



Source: UK House of Commons Library

[68] Relatively small retail banks setup with the intention of competing for business with large, long-established national banks

Key takeaways

Nationalisation directly achieves stability for institutions and restores public confidence, particularly when the entire financial system is under severe stress. However, efforts to turn around the bank and secure good valuations comparable to historical returns for the government when exiting the institution, are typically long-drawn and costly affairs. As the case of RBS demonstrates and assuming HMT's full divestment plan comes to pass, it would take 18 years. The government is also straddled with the prospect of further significant losses. This scenario is likely to be further complicated by the interplay of various factors, including the broader, evolving fiscal and economic conditions, and political and public backlash from crystallised losses to the public purse.

> ***The government should not be in the business of owning banks***
>
> Philip Hammond, former Chancellor of the Exchequer

The complexity of restructuring large institutions with cross-border operations should not be underestimated. The case of RBS offers insights into the different models for executing internal bad banks (and considerations for an external bad bank). It demonstrates the challenges of dealing with multiple legacy issues that repeatedly impede the path to profitability, implementing strategic transformation programmes as envisioned by different CEOs, maintaining investor confidence, and dealing with the political economy, including the pressures of scrutiny by government bodies such as the NAO and OBR as well as post-state aid EU competition concerns.

Regulatory regimes also need to be in step with periods of accelerated growth in the financial sector. In the case of RBS, during its failure, the UK FSA had adopted 'light-touch' regulation, which had focused on market conduct, rather than on prudential requirements and supervision commensurate with RBS's size and aggressive expansion in the 2000s.